APPENDIX

Notes for FOMC Meeting
October 2, 1990
Sam Y. Cross

Underlying sentiment toward the dollar has been negative for some time. But with the outlook for other currencies having become more clouded, the negative sentiment for the dollar seems to have eased somewhat. The biggest exchange rate change in the period since the last meeting was against the yen, with the dollar down by 6 percent. In contrast, the dollar was stable or rose modestly against the other G-10 currencies.

Some traders tell us that with problems seen for so many currencies these days, they see their task as a search for the least bad. With respect to the dollar, there continues to be a lot of attention on the weak U.S. economic fundamentals, and, associated with that, the potential for further declines in U.S. interest rates, which at the short end are already at or below those of other major countries. Also, the Persian Gulf situation has not led to any safe-haven surge in dollar exchange rates, as might have been expected from previous experience. Nevertheless, we suspect that the uncertainties of that situation have been providing the dollar with some support and have eased the dollar's decline. For one thing, we have heard talk of some large purchase orders for dollars coming out of the region, orders which, depending on the story, may be related to precautionary shifts in portfolios, needs for liquid funds, or financing of armaments. For another, market participants still generally believe that, in the event of a real war with real bullets, the immediate reaction would be to rush into dollars, and this prospect has left traders and investors hesitant to short the dollar too much. More recently, the expressions of concern by various officials about the inflationary risks posed by higher oil prices and a declining dollar have given some comfort to market participants and may have helped support the dollar.

With respect to the mark, we have seen a greater recognition of the possible costs and risks inherent in German re-unification. This is not the fear that existed earlier of an immediate inflation surge, but rather disappointment about the extent of dislocation of businesses, of unemployment in East Germany, and of the slowness of capital to be attracted there. This new scenario may mean that interest rates in the near term will not rise as much as earlier believed, and some fear that the longer term consequences for inflation may be more serious.

With respect to the pound sterling and the Canadian dollar, these two currencies have at times been attractive for their combined attributes of high interest rates and oil exporting capabilities. But both are seen as vulnerable to weakening domestic economies and other problems. For sterling there has been disappointment over the timing of entry into the exchange rate mechanism of the EMS and over the persistence of inflation. For the Canadian dollar there has been anxiety over the declining popularity of Mulroney and concern over the political situations in Quebec and Ontario.

Thus, the yen was the only true winner in terms of exchange rate increases in this period. With its 3/4 percent discount rate increase at the end of August, the yen strengthened generally and rose against the European currencies by even a bit more than against the dollar. There are positive factors for the yen, in Japan's very strong domestic growth and in confidence in the bank of Japan's commitment to fight inflation. Yet the yen, too, has its problems, most notably the shakiness of Japanese financial markets. By yesterday, both stock prices and bond prices had fallen by nearly 50 percent this year in an environment of progressively rising interest rates. The domestic economy has continued to be very robust despite these financial market declines. But the bond and stock price declines have adversely affected the earning and balance sheets of Japanese banks and other financial institutions. Particularly in September, these conditions led to a repatriation of funds to Japan as the fiscal half year end approached, and this process contributed to the yen's recent strength. (I should note that this morning there has been a sharp rise in the Nikkei Dow by more than 13%, and also sharp declines in yen short-term and long-term interest rates.)

At the present, market sentiment toward the dollar remains negative but there is a note of caution. There has been a palpable diminution in the conviction with which analysts are forecasting further declines, partly because of the problems facing other currencies, partly because of fears of overt war, partly because the G-7 communique has provided some reassurance that the officials aren't seeking further declines for the dollar. But, there are many reminders of how tenuous the situation is. We have seen new lows against the mark and Swiss franc in this period; the trade-weighted average is at the lowest point we have seen for many years; and there are questions about the prospects for the continued capital inflows, particularly from Japan, that are required to finance the deficit.

Concerning last Sunday's budget package, the initial reaction of the exchange market has been that it removes an obstacle to monetary easing, but generally participants are waiting to see what the Congress does and what the Fed does.

Since the last FOMC meeting, the Desk has not intervened in the foreign exchange market. There have been no further sales of foreign currencies to reduce warehousing, but there have been informal discussions with the Treasury staff about possible additional steps to reduce outstanding warehousing. The Treasury has continued its sale of ESF holdings of SDRs for dollars. As you may recall, the SDRs are sold to IMF member nations who require SDRs to pay Fund charges. Since July 12, a total of SDR 414.1 million, equivalent to $570.1 million, have been sold, out of total sales of 500 million SDRs contemplated.

In other operations during the period, Hungary made final repayments on the first two drawings of its multilateral facility with the ESF and Bank for International Settlements (BIS), and repaid the remaining commitments on its multilateral facility with the ESF, BIS and Kreditanstalt fuer Wiederaufbau, with the ESF receiving payments totaling $13.4 million.

NOTES FOR FOMC MEETING
PETER D. STERNLIGHT
OCTOBER 2, 1990

Domestic Desk operations since the August 21 meeting remained directed at achieving reserve conditions consistent with federal funds trading in the area of 8 percent. Operations were conducted against a background of continuing uneasiness in the financial markets, dominated by uncertainties over the Middle East situation and related inflation worries, but also responsive to concerns about the weak business picture and a growing sense of fragility in the financial sector.

Over the first part of the period, there was a strong presentiment in the markets that an easier policy move was imminent--so much so that the Desk had to take special pains to ensure that routine actions to meet technical reserve needs were not misinterpreted as policy signals. At times this led us to hold back in meeting projected needs because the money market was momentarily comfortable--and when reserve needs finally showed through, late on the August 22 and September 19 settlement dates, the banking system had no choice but pay up sharply for funds and visit the discount window in size. The September 5 settlement date also saw a bulge in borrowing and an elevated funds rate, but that was more due to a large reserve shortfall from projected levels. Taken together, these settlement day reserve shortages resulted in an appreciably higher average borrowing level than the $500 million path allowance (averaging about $800 million for the period since the last meeting through the past weekend), and a funds rate that averaged about 8.20 percent over the same period.

The funds rate remained high in the current reserve maintenance period, but for a different set of reasons--essentially a combination of the approaching calendar quarter end and very cautious reserve management by money center banks whose names were coming under question in the financial markets--or who feared that their names could come into question. Following some fairly aggressive reserve provisions by the Desk last week, more than meeting projected needs, the funds rate eased off by mid-morning on the quarter end date last Friday. This left us looking yesterday at an estimated overabundance of reserves--though some firmness had returned to the money market and we took no action to drain reserves.

The market's expectation of imminent Fed easing faded back during the period, particularly after the Chairman's September 10 JEC testimony, which was interpreted as placing inflationary worries ahead of immediate concerns about the economy. Still, there remains a smoldering anticipation of easing somewhere down the road in light of the perceived weakness of the economy. The past weekend's leadership agreement on budget deficit reduction measures seems to have rekindled some expectations of an early easing although skepticism remains on whether the Congress will follow through.
Even aside from the budget one gets a sense that some manner of accommodation is expected to lie ahead in view of what is perceived as an anemic economy and fragile financial system.

Facing reserve needs from a variety of factors, including large continuing increases in currency in circulation, and a temporary very large rise in Treasury balances after the September tax date, the Desk was generally on the reserve-supplying side during the intermeeting period. Outright holdings of Treasury issues were increased by $3.6 billion, mainly through a market purchase of bills on August 29, supplemented by outright purchases of bills from foreign accounts on a number of days. System repurchase agreements were arranged on 13 days, including several occasions when we used fixed maturities of up to a week to make sure the reserves stayed out there. Customer related repos were used on just three occasions. Last week, faced with mounting quarter-end pressures in the money market and a nervous and cautious atmosphere in which some major money center banks either experienced or perhaps feared difficulty in having their names accepted as counterparties, we arranged overnight System repos on four successive days, deliberately getting somewhat ahead of the projected reserve need in order to relieve the threatening atmosphere.

Market interest rates responded to a variety of cross currents during the period, differentiating instruments by maturity and perceived quality. At the short end, there was an abatement of expectations of imminent Fed easing though day-to-day reports on budget negotiations kept the spark of an early move alive and that spark was fanned further by this past weekend's leadership agreement. A more pronounced influence on short-term rates as the period progressed was the heightened sense of quality concerns, sending more investors to the safety of Treasury securities. Bill rates were down by 15 to 40 basis points with the larger declines among the shorter maturities. In yesterday's bill auctions--which could be held thanks to last minute congressional action to provide a few days' extension on the temporary debt ceiling, the 3- and 6-month rates were 7.18 and 7.21 percent, down 37 and 24 basis points, respectively, from those just before the last meeting. In addition to quality concerns, demand was also bolstered by the maturing of some $20 billion of cash management bills after the September tax date. On net, reflecting this repayment, the Treasury paid down about $7 billion in the bill area.

In contrast to the decline in bills, rates on commercial paper and major bank CDs were about unchanged over the period. Thus the spread between 3-month Treasury bills and LIBOR widened by about 35 basis points and the TED spread, which compares the rate on Treasury bill futures with that on Eurodollar CD futures, widened by 50 basis points over the period to about 130 basis points. This spread had remained fairly narrow in earlier months even though some level of quality concerns had been affecting longer term bank-related paper for a considerable time.

Looking at longer maturities, there was also a mixture of developments with differential effects based on quality as well as general rate effects tied to perceptions of the economy, inflation, and monetary policy. For longer term Treasury issues, where about $15 billion of new money was raised, the period netted out to a small decline in yields--around 10 basis points--partly with the benefit of a sizable price gain yesterday on the heels of a drop in oil prices and the leadership agreement on the outlines of a deficit reduction package. Through much of the period, however, long Treasury rates were some 10-15 basis points higher than they were just before the Committee's August meeting, chiefly reflecting concerns over higher oil prices and general worries about inflation despite the widely held view that the economy is quite soft. At times the long end rallied a bit on anticipation of a deficit reduction package, temporary softenings in oil prices and indications of stronger Federal Reserve resolve to resist inflation. In the closing days of the period, in addition to greater optimism on the budget and yesterday's drop in oil prices, an added source of support for long Treasuries was the increasing sense of investor concern with the soft stock market and weakness in the longer term corporate bond sector--especially for issues deemed to be of lesser quality. Even so, the atmosphere surrounding long Treasuries remained fragile, highly subject, among other things, to developments in the Middle East, with its virtually imponderable consequences for oil prices and the budget outlook.

In contrast to the modest decline for longer term Treasury yields over the period, yields on other longer term debt were generally higher--slightly so in the case of highly rated corporate issues, and much more substantially in the case of lesser rated issues. The spread of one broad index of high yield bonds over Treasury issues widened by about 165 basis points over the period, while another such index widened by over 300 basis points. Quoted spreads on some major money center bank holding company bonds over Treasuries were eye-catching, widening by some 200 basis points or more, as investors grew quite uneasy about the quality of bank assets and questioned the extent to which safety net considerations would extend to holding companies. This same factor took its toll on bank equities, as prices of some major bank stocks tumbled on the order of 20-30 percent or several times the drop in the broad S&P 500 stock index over this period.

This seems to be an exceptionally difficult time to assess what it is that the long term markets "expect" of monetary policy or how they might react to a more accommodative stance. My sense of it, offered without deep conviction, is that the widely held perception of a soft economy provides a backdrop against which what would be regarded as a meaningful budget accord could get a fairly good reception from the markets--but given the concerns over stubborn inflation I would not look for a really major rally. A Fed easing move in that context would, I think, be accepted but not hailed as a major reason for significantly lower rates. Meantime an easier Fed stance before there was convincing evidence of a credible deficit reduction package would have the potential for an adverse reaction at the long end--unless the business picture were perceived to be considerably weaker than the roughly flat to slightly declining view that seems to be a common expectation now.

Michael J. Prell
October 2, 1990

FOMC BRIEFING -- ECONOMIC OUTLOOK

As you know, there were some notable changes in the Greenbook forecast this month. In particular, we lowered our projection for output growth to small negatives in the next two quarters and we raised our prediction for near-term inflation.

There were several considerations that led us to make these modifications. The first, and foremost, is that oil prices have moved much higher than we previously had assumed they would. Second, recent data--particularly those for the CPI--have suggested that, apart from oil price effects, underlying inflation trends may well be worse than we had anticipated in our last forecast. Moreover, the leaks from the budget summit pointed to bigger increases in excise taxes than we had been assuming; as it turned out, the proposed increases are even greater than we anticipated in this Greenbook. Finally, with the recent intensification of pressures on the banking system, the credit crunch phenomenon seems likely to have more bite, for longer, than we earlier had assumed.

One thing missing from this list of adverse surprises is news on the real economy. The fact is that the incoming data on current spending and forward commitments have not provided clearcut indications that we are headed toward even a mild recession. Indeed, though the latest figures have been predominantly negative, if it weren't for the oil shock and the gloominess of the anecdotal information, one might almost have been tempted to view the recent data as random variations around previous trends, rather than as possible signs of a turning point in the economy.

Consider, as a key case in point, consumer spending. Although real outlays currently are estimated to have been essentially unchanged in August, the July-August average stands well above that of the second quarter. And, even allowing for the uncertainties of seasonal adjustment around the end of the model year, it is difficult to argue that auto demand looked weak in the first 20 days of September. Nonetheless, we are inclined to think that the slice being taken out of real income by soaring energy costs will soon translate into a significant weakening in consumer spending. This is, of course, the cornerstone of our near-term forecast.

Similarly, one can't yet find clear evidence of the impending contraction in capital spending we have predicted. To be sure, the leading indicators of nonresidential construction activity have been weak--but no weaker than they've been for some time now. And that weakness has yet to produce the kind of downturn in spending we've expected. Yesterday's data on construction put in place in August showed an appreciable drop in private nonresidential building, but that only reversed July's surprising surge.

On the equipment side, the August figures on orders for nondefense capital goods were down sharply, which certainly is consistent on the surface with scattered reports of some recent hesitation in spending. However, on closer inspection the message of the data becomes less compelling. First, the bulk of the August decline was in the aircraft component, where huge backlogs almost guarantee a healthy volume of shipments for quite some time. Second, most of the rest of the decline in orders was in the volatile computer component, which may have been temporarily depressed as firms awaited the introduction of IBM's new mainframes.

So, while we think it reasonable to expect that slower consumer demand will have a distinctly negative effect on investment in coming months, we again are hard-pressed to prove it's coming.

Finally, in the housing sector, starts in August were a bit weaker than we had expected, and prices of new and existing homes suggest that demand is lagging. The oil-induced hit to real income should further reduce demand. But, even the greater decline in residential investment we've built into this forecast is not enough, given the size of the sector, to tip the scales for the economy as a whole.

I could go on, but I think what I've said should suffice to illustrate what I suggested earlier: namely, that, our forecast of an economic contraction rests not so much on any obvious tendencies in the data in hand as on an inference from the assumed pattern of developments in the international oil market.

Despite the perceptibly weaker projection for business activity, we have retained our previous conditioning assumption that the federal funds rate will remain around 8 percent. In part, this decision reflects the thought that a stimulus to aggregate demand in response to a supply shock of the sort we have experienced would tend to reinforce tendencies toward a deterioration in ongoing inflation. But, it also reflects the fact that, if oil prices come down as assumed, the boost to real disposable income should be stimulating renewed growth in demand about the time any monetary accommodation would take effect. And, in addition, the fact that the dollar has declined appreciably this year, without any consistent connection to oil price movements, buttresses our view that the trade sector should be a plus for domestic activity in coming quarters.

Of course, these developments on the real side have their counterpart on the price front. The assumed decline in oil prices and the expected slack in labor and industrial capacity result in a projection that consumer price inflation will be back in the vicinity of 4-1/2 percent a year from now--and moving downward in 1992.

Apart from the obvious possibility that events in the Middle East could result in a vastly different outcome for oil prices than we have assumed, two other major uncertainties in this forecast were the budget situation and the credit crunch.

As regards fiscal policy, it clearly will be a while longer before we can say precisely what budget program will be implemented. As the note we distributed this morning indicates, the summiteers' package nominally is of about the same overall size as we assumed for fiscal 1991 and '92. But the risk at this point almost surely is that the slippages in the process from here on will result in a somewhat lesser degree of fiscal restraint.

As regards the credit situation, our assessment is that things are continuing to deteriorate. Concerns about credit quality appear to be surfacing more in the market interest rate structure, but of greater importance, the recent developments in the banking industry point to an increasing stringency in the supply of credit to borrowers dependent on intermediaries. We are in no better position to quantify the effects than we were earlier, but this phenomenon has affected our thinking about prospects for aggregate demand; notionally, we have the mounting stress in the financial sector retarding growth for several more quarters.

October 2, 1990

FOMC BRIEFING
Donald L. Kohn

On top of the already difficult problem of assessing the underlying state of the economy, the policy decision today must be made in the context of unusual uncertainties about oil prices, credit conditions, and, still, to a degree, fiscal policy. Mike has already discussed these areas as they are incorporated in the greenbook forecast. I thought it might be useful to expand a bit on the implications of potential developments in oil, budget, and credit for monetary policy and for financial variables. In an environment of unusual uncertainties about the economy and key influences on it, the interpretation of financial variables might be especially difficult, but especially important as well, since they may be the first visible manifestations of underlying developments in the economy and prices.

Oil price contingencies and possible policy responses were discussed extensively at the last Committee meeting. It was noted at that time that some attention to nominal GNP in keying policy decisions might be helpful in avoiding cumulative missteps in either direction in a tricky situation. If the appropriate path for nominal GNP were seen as something like the one the Committee would have considered acceptable in the absence of an oil shock, it could be attained, at least in modelling exercises, by holding to the monetary policy that also would have prevailed without an oil shock.

Unfortunately, the concept of "the policy that otherwise would have prevailed" becomes increasingly abstract as time goes on, especially in a situation in which both interest rates and money demand seem to be affected by oil price movements. And, we do not yet have a read on the effect of oil prices on nominal GNP for a given monetary policy. In the greenbook, where the higher assumed path for oil prices was a key change in the outlook, nominal GNP is very slightly lower over the next year or so, with short-term interest rates essentially unchanged from the last projection. In financial markets, oil prices and yield curves seem to be moving together. To be sure, this correlation could reflect changing liquidity or uncertainty premiums, but it also may indicate that the markets perceive that higher oil prices, for example, by adding to longer-term inflation pressures, are more likely to require an increase than a decrease in interest rates to achieve what participants perceive to be the Committee's objectives.

Unfortunately, money flows following the oil shock also are somewhat ambiguous indicators of the likely effects of policy on nominal spending. M2 growth has strengthened in the last two months, but remains below the midpoint of its long-run range. Moreover, at least some of that strength seems to be an aspect of the increased demands for liquidity associated with heightened uncertainty. From a policy perspective, the somewhat conflicting market signals, along with the general notion that little change in rates is consistent with taking the supply shock about equally in higher prices and lower output, provide support for the Committee's cautious approach to reacting to oil price developments _per se_.

Instead, developments in fiscal policy and credit markets, against the backdrop of general economic conditions, may be more likely to key policy actions over the intermeeting period. With regard to fiscal policy, the Federal Reserve may be seen as having a commitment to easing monetary policy in response to a credible, sizable, multiyear deficit reduction package, especially one that is validated by a rally in bond markets.

Bond yields have in fact fallen since the agreement seemed more likely--by nearly 40 basis points since the middle of last week. However, as Peter remarked, part of this rally owed to the drop in oil prices yesterday, and another part to the anticipated response by the System, not necessarily to expectations of the restraining effect of fiscal policy on the economy. The yield curve is still basically upward sloping--at least beyond the near-term, which is dominated by expected monetary policy. While the shape of the yield curve may reflect in part uncertainty or liquidity premiums, it does not suggest that a "tight" monetary policy is at present keeping a floor under rates.

A further substantial bond market rally after final passage of needed legislation, while indicating a credible fiscal policy, would not necessarily signal a need for a significant easing of monetary policy. Fiscal restraint in the package is heavily weighted toward the out years, and to the extent a sizable further drop in bond yields represented anticipated fiscal restraint to come much later, it could exert a degree of stimulus to the economy over the intermediate term, especially if the market response included an appreciable decline in the dollar, even in the absence of monetary policy actions. No such actions are assumed in the greenbook forecast which, as Mike noted, already incorporates about the degree of restraint in the agreement for 1991-92, and bond yields and foreign exchange rates near current levels, at least for a time. The administration forecast is roughly in line with the greenbook, and also assumes short-term rates close to current levels over the next year.

As has already been discussed, an important area of risk to the forecast involves developments in credit markets. The survey evidence on availability constraints is spotty and a bit dated. Those results, from banks and small businesses, suggested some tightening of standards through August and perhaps beyond. Credit flows to private borrowers have been moderate, with notable areas of weakness. Business loans at banks declined slightly in August and September, abstracting from merger-related lending; while increases in commercial paper have been sizable, long-term debt issuance has fallen to unusually low levels, and overall business debt growth looks quite sluggish. Real estate lending at banks dropped off sharply in August and remained at that slower pace in September, likely reflecting the long awaited collapse of commercial lending.

The odds on a significant further tightening of credit terms would seem to depend importantly on the extent and duration of the problems at a number of large banks that have recently captured market attention, and on any tendency for confidence to erode more widely through the banking system or at other intermediaries. Affected institutions, facing increases in the cost of capital and liabilities more generally, are likely to reduce lending and attempt to bolster profit margins. There were on occasion last week disquieting signs of finance companies being called into question, and risk premiums tended to widen in a number of sectors in addition to banking. Still, many of those spreads outside of banking remain narrow by historic standards, and spreads, including those for banks, generally came back in yesterday, perhaps reflecting the passing of quarter-end window dressing activities. In spot checks with a few banks last week, most lending officers reported that they had not tightened lending terms or credit standards further since August, though loan growth was depressed by weak demand.

The effect of bank problems on the monetary aggregates is difficult to predict. Pressures to hold down deposit offering rates would arise from desires to bolster profits and from reduced funding needs as asset growth slowed further. On the other hand, aggressive bidding for retail deposits could develop as uninsured sources of funds become harder to obtain. Such bidding was the pattern in the early stages of the thrift problems, and has recently become more prevalent in New England. Under these circumstances M2 could be boosted over the short run by attempts to replace wholesale with retail funding, but held down over the longer term in keeping with slower growth in assets and M3. Strong money growth over coming months would not provide much comfort if the problems in the banking system seemed to be deepening, but weak M2 might be a sign of serious disruption in the intermediation process.

Against this background, the Committee in practice would seem to have three options, broadly defined, to chose among for policy over the intermeeting period. One would be a fairly aggressive easing posture, likely to result in a half point drop in the federal funds rate in coming weeks, as under alternative A. This option might be appropriate if the economy were seen to be in danger of substantially greater weakness than thought needed to contain inflation, from credit contraction, fiscal restraint or other causes. One approach to this option would be to ease immediately by 25 basis points, and follow that with an additional 25 basis points once fiscal restraint was assured. Whether intended or not, the initial ease would be interpreted as a response to changed fiscal prospects, and so consideration might be given to finding a public forum for the Chairman to explain the broader context. Interest and exchange rates would probably decline under this alternative, which encompasses greater ease than the market is expecting. The extent of the drop in bond yields over time might depend on the behavior of the dollar, and on whether data confirmed that the economy was in fact sufficiently weak that a more expansive monetary policy would not intensify longer-run inflation pressures.

A second option might be for a smaller easing of around 25 basis points, perhaps keyed in its timing to the budget situation. This would imply a delay in implementation until after the budget picture clarified; by that time, information on employment also would be available. A modest easing could be coupled with an asymmetrical directive to facilitate further action should the underlying situation in the economy or financial markets deteriorate relative to Committee expectations. This option for easing is about in line with market expectations, and should have no major effects on interest or exchange rates.

A third option would be to maintain current reserve conditions, even following passage of a fiscal package like the one proposed. Such a choice would be based on the notion that the proposed fiscal policy, perhaps in light of its time profile, and current conditions more generally, were not likely to result in weakness in the economy over coming quarters beyond that needed to contain inflation. The lack of policy action might be seen by some as a failure to follow through on a promised policy ease, and in any case would disappoint market expectations slightly. Once it became clear that policy was not going to ease following the budget accord, short-term rates would back up a little and bond yields also might rise. The longer-term response of bond markets might be more favorable, however, reflecting a continuing sluggish economy and damped inflation expectations.